

11/24/00

09/18/00 11/24/00

BERESKIN & PARR

BOX 401, 40 KING STREET WEST, TORONTO, CANADA M5H 3Y2  
PHONE (416) 364-7311 • FAX (416) 361-1398 • WWW.BERESKINPARR.COM

PTO/SB/05 (08-00)

Please type a plus sign (+) inside this box



Approved for use through 10/31/2002. OMB 0651-0032  
U.S. Patent and Trademark Office; U.S. DEPARTMENT OF COMMERCE

Under the Paperwork Reduction Act of 1995, no persons are required to respond to a collection of information unless it displays a valid OMB control number.

# UTILITY PATENT APPLICATION TRANSMITTAL

(Only for new nonprovisional applications under 37 CFR 1.53(b))

Attorney Docket No. 11483-80  
First Inventor Ron S. DEMBO et al.  
Title METHOD OF PORTFOLIO VALUATION  
Express Mail Label No. 1059

## APPLICATION ELEMENTS

See MPEP chapter 600 concerning utility patent application contents.

- ☐ Fee Transmittal Form (e.g., PTO/SB/17)  
*(Submit an original and a duplicate per fee processing)*
- ☐ Applicant claims small entity status.  
See 37 CFR 1.27.
- ☒ Specification [Total Pages 45]  
*(Preferred arrangement set forth below)*
  - Descriptive title of the invention
  - Cross Reference to Related Applications
  - Statement Regarding Fed sponsored R & D
  - Reference to sequence listing, a table, or a computer program listing appendix
  - Background of the invention
  - Brief Summary of the invention
  - Brief Description of the Drawings (if filed)
  - Detailed Description
  - Claim(s)
  - Abstract of the Disclosure
- ☒ Drawing(s) (35 U.S.C. 113) [Total Sheets 14]
- ☐ Oath or Declaration [Total Pages 1]
  - ☐ Newly executed (original or copy)
  - ☐ Copy from a prior application (37 CFR 1.63 (d))  
*(for continuation/divisional with Box 17 completed)*
    - ☐ **DELETION OF INVENTOR(S)**  
Signed statement attached deleting inventor(s) named in the prior application. see 37 CFR 1.63(e)(2) and 1.33(b).
- ☒ Application Data Sheet. See 37 CFR 1.76

ADDRESS TO: Assistant Commissioner for Patents  
Box Patent Application  
Washington, DC 20231

- ☐ CD-ROM or CD-R in duplicate, large table or Computer Program (Appendix)
- ☐ Nucleotide and/or Amino Acid Sequence Submission  
*(if applicable, all necessary)*
  - ☐ Computer Readable Form (CRF)
  - ☐ Specification Sequence Listing on:
    - ☐ CD-ROM or CD-R (2 copies); or
    - ☐ paper
- ☐ Statements verifying identity of above copies

## ACCOMPANYING APPLICATION PARTS

- ☐ Assignment Papers (cover sheet & document(s))
- ☐ 37 CFR 3.73(b) Statement of Power of Attorney  
*(when there is an assignee)*
- ☐ English Translation Document (if applicable)
- ☐ Information Disclosure Statement (IDS)/PTO-1449 [Copies of IDS Citations]
- ☐ Preliminary Amendment
- ☐ Return Receipt Postcard (MPEP 503)  
*(Should be specifically itemized)*
- ☐ Certified Copy of Priority Document(s)  
*(if foreign priority is claimed)*
- ☐ Other: .....

17. If a CONTINUING APPLICATION, check appropriate box, and supply the requisite information below and in a preliminary amendment, or in an Application Data Sheet under 37 CFR 1.76:

☐ Continuation ☐ Divisional ☐ Continuation-in-part (CIP)

of prior application No. \_\_\_\_\_

Prior application information:

Examiner \_\_\_\_\_

Group / Art Unit \_\_\_\_\_

For CONTINUATION OR DIVISIONAL APPS only: The entire disclosure of the prior application, from which an oath or declaration is supplied under Box 5b, is considered a part of the disclosure of the accompanying continuation or divisional application and is hereby incorporated by reference. The incorporation can only be relied upon when a portion has been inadvertently omitted from the submitted application parts.

## 18. CORRESPONDENCE ADDRESS

☒ Customer Number or Bar Code Label



or ☐ Correspondence address below

Name	Bereskin & Parr				
	Box 401				
Address	40 King Street West				
City	Toronto	State	Ontario	Zip Code	M5H 3Y2
Country	Canada	Telephone	(416) 364-7311	Fax	(416) 361-1398

Name (Print/Type)	H. Samuel Frost	Registration No. (Attorney/Agent)	31,696
Signature			Date November 24, 2000

Burden Hour Statement: This form is estimated to take 0.2 hours to complete. Time will vary depending upon the needs of the individual case. Any comments on the amount of time you are required to complete this form should be sent to the Chief Information Officer, U.S. Patent and Trademark Office, Washington, DC 20231. DO NOT SEND FEES OR COMPLETED FORMS TO THIS ADDRESS. SEND TO: Assistant Commissioner for Patents, Box Patent Application, Washington, DC 20231.

1c930 U.S. PTO  
09/18/00

11/24/00

**Initial Information Data Sheet****Inventor Information**

Inventor One Given Name:: Ron  
Family Name:: Dembo  
Postal Address Line One:: 398 Markham Street  
City:: Toronto  
State or Province:: Ontario  
Country: Canada  
Postal or Zip Code: M6G 2K9  
Citizenship Country:: Canada

Inventor Two Given Name:: Helmut  
Family Name:: Mausser  
Postal Address Line One:: 2401 - 260 Queen's Quay West  
City:: Toronto  
State or Province:: Ontario  
Country: Canada  
Postal or Zip Code: M5J 2N3  
Citizenship Country:: Canada

**Correspondence Information**

Name Line One:: H. Samuel Frost  
Name Line Two:: Bereskin & Parr  
Address Line One:: Box 401  
Address Line Two:: 40 King Street West  
City:: Toronto  
State or Province:: ONT  
Country:: Canada  
Postal or Zip Code:: M5H 3Y2  
Telephone One:: (416) 957-1687  
Telephone Two:: (416) 364-7311  
Fax:: (416) 361-1398  
Electronic Mail:: sfrost@bereskinparr.com

**Application Information**

Title Line One:: METHOD OF PORTFOLIO VALUATION  
Total Drawing Sheets:: 14  
Formal Drawings?: No  
Application Type:: Utility  
Docket Number:: 11483-80

004247 005260

**Representative Information**

Representative Customer Number:: 001059

**Prior Foreign Applications**

Foreign Application One:: 2,290,888  
Filing Date:: November 26, 1999  
Country:: Canada  
Priority Claimed:: Yes

0043110059450

BP #11483-80

BERESKIN & PARR

UNITED STATES

Title: METHOD OF PORTFOLIO VALUATION

Inventors: RON S. DEMBO  
HELMUT MAUSSER

Title: METHOD OF PORTFOLIO VALUATION

**FIELD OF THE INVENTION**

This invention relates to a system and method for valuing portfolios. More specifically, this invention relates to a computer-based  
5 system and method for valuing a portfolio in terms of values related to its future performance as determined by simulations, relative to a benchmark.

**BACKGROUND OF THE INVENTION**

10 Risk management systems are commonly employed by financial institutions, resource-based corporations, trading organizations, governments, and other users to aid in the assessment and management of risk associated with the operations of the user.

One popular example of a known risk management system is  
15 the RiskWatch V3.1.2 system, sold by the assignee of the present invention. This system allows users to employ models of financial instruments in the user's portfolio. The system evaluates the models at appropriate time intervals in view of a range of different possible scenarios. Each scenario comprises a set of values for risk factors employed  
20 in the models at each time interval, and each scenario has an assigned probability. Resulting attributes or risk values of the instruments when evaluated under each scenario at each time interval of interest are then used to produce one or more measures of risk (i.e. one or more risk metrics), which are examined to assess the risk to the user of holding the  
25 portfolio of instruments under the evaluated scenarios. One common risk value is the monetary value of the instrument or instruments under consideration, although other risk values including deltas, gammas and other computed values may also be employed. By combining these risk values appropriately, desired risk metrics can be obtained so that the user  
30 can, for example, identify opportunities for changing the composition of the portfolio, to reduce the overall risk of the portfolio or to achieve an acceptable level of risk.

004427 00587260

Many prior art risk management systems and methods, however, require that broad simplifying assumptions (e.g. changes in certain values are normally distributed) be made for instruments which do not exist, or more specifically, for instruments which will not be created  
5 until some point in the future. This may be the case for a 90-day treasury bill (T-Bill) whose start date is two years away, for example. Simplifying assumptions must also be made for instruments for which appropriate pricing information is not available. These simplifying assumptions are made even in circumstances when such assumptions may be in conflict  
10 with the conditions that apply under one or more scenarios.

Instruments I are not limited to financial instruments and can include other instruments, including insurance instruments and commodity options, for example. While an instrument I will most commonly be a financial instrument such as a stock, bond, derivative  
15 product, or insurance product for example, generally, an instrument I may be any model which accepts one or more risk factors to simulate a characteristic of a real-world entity including the likelihood of a default by a counter party, for example.

Also, in many known risk assessment systems and methods,  
20 risk and reward are assessed on the basis of historical information, in particular, the past performance of the instruments in a portfolio. These systems and methods typically assume, explicitly or implicitly, similar performance in the future, which in some instances, leads to inaccurate results. Many risk assessment systems and methods ignore issues related  
25 to the aging of investments, which include the effects of bond coupons maturing into cash, and of the investment instruments maturing, for example. Liquidity restrictions on instruments in a portfolio, changes in market rates, credit spreads and credit downgrades can also have a significant impact on the value of a portfolio. However, the effects of  
30 market, credit, and liquidity risks and the modeling of the correlation between these types of risks are not often dealt with adequately by existing risk assessment systems and methods.

Further, evaluating the trade-off between risk and return in prior art risk management and risk assessment systems and methods may be a prohibitively time-consuming and difficult task, particularly when a user's portfolio is large.

5           It is known that the trade-off between risk and return can be expressed in a concise manner by means of what is known as an "efficient frontier", which allows the optimal trade-offs between competing objectives to be identified. A classic example of this concept is the Markowitz mean-variance efficient frontier which trades off risk, as  
10   measured by variance of portfolio returns, and expected return. In this context, portfolios that earn the greatest return for a given amount of risk (or conversely, that incur the lowest risk to obtain a given level of return) are said to be efficient.

Utility theory may then be applied to determine the  
15   composition of an investor's optimal portfolio, where the portfolio is defined by a point on a constructed Markowitz efficient frontier. More specifically, given a risk-averse investor, an attainable portfolio which maximizes return for a specified level of risk and which has the highest utility for the investor lies on the efficient frontier, and can be identified  
20   using an investor's utility function. A utility function quantifies the desirability of a particular out-come, with higher values indicating greater desirability.

Although it is widely applied, the Markowitz mean-variance framework for trading off risk and reward has certain drawbacks, including  
25   its inherent assumptions that returns are normally distributed, and that portfolios are static over time. These assumptions are routinely violated, for example, by portfolios containing optionality, which in addition to displaying non-normal returns, are typically rebalanced at regular intervals. Furthermore, constructing a Markowitz efficient frontier  
30   requires one to solve a quadratic program, which can be particularly time-consuming when the subject portfolios are large.

Traditional mean-variance measures and other risk-adjusted

004800-1440

measures which may be used to evaluate the performance of an investment, or to aid in the ranking of such investments, are also known in the prior art. For example, Morningstar's risk-adjusted rating is a measure used to rank mutual funds relative to a specified benchmark instrument (i.e. U.S. T-Bills). In measuring a mutual fund's risk, the expected losses of the mutual fund relative to the benchmark instrument are calculated and averaged. In measuring a fund's return, the difference between the cumulative value obtained by investing \$1 in the mutual fund and the cumulative value obtained by investing \$1 in the benchmark instrument is calculated. The relative returns for all the funds of a group are calculated by dividing each of the risk and return measures obtained by an appropriate base for the group, and may be subsequently ranked.

However, like many other traditional performance measures, the calculation of Morningstar's risk-adjusted ratings assumes that the statistics from historical frequency distributions are reliable predictors of corresponding statistics from a probability distribution of future returns. Furthermore, Morningstar's risk-adjusted ratings are often used to evaluate the performance of a single fund, and do not typically incorporate information on correlations between multiple funds in a portfolio.

Accordingly, a forward-looking risk management system, framework and methodology was developed by the assignee to provide for a more effective and efficient means of calculating performance measures and the trade-off between risk and reward for different sources of risk including market, credit, and liquidity risk, in a single, unified framework. The system, framework and methodology for determining and analyzing risk as described in U.S. Patent Application No. 09/323,680 addresses many of the disadvantages of prior art risk management and risk assessment systems. This system, framework and methodology will be referred to in this specification as the Mark-to-Future (MtF) framework.

The MtF framework provides a foundation on which to construct efficient frontiers and to calculate a wide variety of risk/reward performance measures. Using a scenario-based approach, the MtF



framework does not place restrictions on the underlying risk factors or return distributions, and is able to incorporate effects related to the dynamic nature of portfolios, including the effects of cash settlement and active trading strategies, for example. The scenarios can be chosen to reflect not only historically-consistent events, but also extreme future possibilities that may be particularly damaging or rewarding for the portfolio. The scenarios can also be chosen to reflect the constraints imposed on investors in terms of the trades that they are able to execute. The limitations imposed by the finite liquidity of financial markets (i.e. typically, as the size of a trade increases, so too does the investor's per unit cost) can also be incorporated in an analysis within the framework.

Several scenario-based models for analyzing the trade-off between risk and reward are known in the prior art. For example, evaluation of the trade-off between a portfolio's expected profit and expected downside relative to a benchmark has been discussed in U.S. Patent No. 5,799,287, and in Dembo and Rosen, *The practice of portfolio replication: A practical overview of forward and inverse problems*, Annals of Operations Research, vol. 85, 267-284 (1999).

#### SUMMARY OF THE INVENTION

The invention relates to a simple, intuitive model which can be used to assess the trade-off between risk and reward with respect to a portfolio's performance under a range of future scenarios. The invention provides for an improved scenario-based model which does not require an explicit normalization constraint for scaling purposes.

The invention also provides for a system and method for constructing efficient frontiers and obtaining performance measures using information inherently contained in the scenarios of an MtF framework. The invention readily accommodates liquidity and other trading constraints, and allows for the quantification of the costs related to these constraints.

The invention also provides for a system and method for

pricing new securities, and for pricing portfolio insurance for a given portfolio within the MtF framework.

The invention also provides for a method of portfolio valuation and a system adapted to perform the method, in which the overperformance and underperformance of a portfolio under each of a number of different future scenarios relative to a benchmark are calculated. This permits a portfolio to be valued in terms of its "Put Value" and "Call Value", values which are functions of the portfolio's underperformance and overperformance under the different scenarios relative to a benchmark, respectively.

#### **BRIEF DESCRIPTION OF THE DRAWINGS**

For a better understanding of the present invention, and to show more clearly how it may be carried into effect, reference will now be made, by way of example, to the accompanying drawings which show a preferred embodiment of the present invention, and in which:

Figure 1 shows a schematic representation of a prior art mark-to-market valuation of an instrument;

Figure 2 shows a schematic representation of a prior art mark-to-future valuation of an instrument for a single scenario;

Figure 3 shows a flowchart of a prior art method of determining a risk metric in the form of a distribution of portfolio values and probabilities;

Figure 4 shows a probability versus value distribution produced by the method of Figure 3;

Figure 5 is a schematic diagram illustrating a portfolio Mark-to-Future cube;

Figure 6 is a schematic diagram illustrating a computer system implementing the Mark-to-Future framework;

Figure 7a is a schematic diagram illustrating a portfolio as comprising a distribution of unrealized upside gains and downside losses;

Figure 7b and 7c are schematic diagrams illustrating the

payoffs of a portfolio representing upside and downside respectively;

Figures 8a and 8b are graphs which model the liquidity costs of holding a given security;

Figure 9 is a graph illustrating an example of a Put/Call  
5 Efficient Frontier;

Figure 10 is a graph illustrating an example of a Put/Call Efficient Frontier showing an arbitrage opportunity;

Figure 11 is a graph illustrating how a portfolio is selected based on utility;

10 Figure 12 is a graph illustrating how a portfolio is selected based on utility and absolute risk tolerance; and

Figure 13 is a flow chart diagram illustrating the steps performed by the method of use of the present invention.

#### **DETAILED DESCRIPTION OF THE INVENTION**

15 For clarity, before discussing the present invention in detail, a more detailed discussion of prior art risk management systems will be provided with reference to Figures 1 through 4. Figure 1 shows a representation of a known mark-to-market function for an instrument I in a defined portfolio of instruments P (not shown). Referring to Figure 1,  
20 a model M has been created for the instrument I under consideration. Model M takes one or more risk factors  $rf_i$  as input and, generally, a time input T, which it then processes for instrument I to obtain a risk value V.

Model M also accepts a calibration value C, as necessary to calibrate the model to current conditions.

25 The term "risk value" is intended to comprise any suitable measure of risk for the instrument. V can be the monetary value of the instrument or can be another derived risk value, such as a delta, gamma or sensitivity value, expressed in appropriate units. Further, V need not be a single value, as multiple values such as a delta and a gamma can be  
30 determined and stored if desired.

Risk factors can comprise a variety of data, including interest rates or rate spreads, and foreign exchange rates, for example. Further, instruments  $I$  are not limited to financial investment instruments and can include other instruments, including insurance instruments and commodity options, for example. While an instrument  $I$  will most commonly be a financial instrument such as a stock, bond, derivative product, or insurance product for example, generally, an instrument  $I$  may be any model which accepts one or more risk factors to simulate a characteristic of a real-world entity, including the likelihood of a default by a counter party, for example.

In order to accurately determine future risk values of an instrument  $I$ , it is first necessary to determine the present risk value, or mark-to-market value, for the instrument  $I$  and to calibrate the model  $M$ . Referring to Figure 1, risk factors  $rf_1$  through  $rf_i$  are assigned their present actual (or best estimated) values,  $T$  is assigned a zero value corresponding to present time, and  $V$  is determined. A calibration value  $C$  is determined and applied to  $M$  to ensure correspondence of the determined value  $V$  and the actual risk value of  $I$  at the present time. Calibration value  $C$  is stored for model  $M$  and is employed for all further calculations until the model is re-calibrated at a new time  $T=0$ .

Once all models  $M$  for all instruments  $I$  in portfolio  $P$  are calibrated and mark-to-market risk values are determined for each instrument  $I$  in portfolio  $P$ , the risk analysis can be performed for  $P$  by applying a set of possible future scenarios and a time  $T$  to models  $M$  to obtain mark-to-future risk values for each instrument  $I$ . A scenario  $s$  (not shown) comprises a vector with a value for each risk factor  $rf_i$  employed by a model  $M$  in portfolio  $P$ , and each scenario has associated with it a probability of its likelihood of occurrence. Figure 2 shows model  $M$  being evaluated at a selected time  $T$  under scenario  $s_1$ , to produce a value  $V_1$  which is the risk value of instrument  $I$  at time  $T$  for the values of the risk factors defined in scenario  $s_1$ .

Figure 3 is a flowchart illustrating a prior art method of producing a risk metric for a predefined portfolio P.

At step 30, an outer loop for portfolio P is established to process each scenario s in turn.

5           At step 34, an inner loop is established to process each instrument I in turn.

At step 38, the risk value V of the present instrument I under consideration for the present scenario s is determined.

10           At step 42, a determination is made as to whether any other instruments I remain to be considered. If the condition is true, the flow of method steps proceeds to step 34 and the next I is selected and considered. If the condition is false, the flow of method steps proceeds to step 46, at which the determined values for the instruments I are summed to get a total risk value for the portfolio P which is stored, along with the probability assigned to scenario s. If there are multiple units of instruments I in portfolio P, the total risk value calculated at step 46 is weighted accordingly (e.g. multiplying the value of an instrument I by the number of units of that instrument, the product used in calculating the total risk value).

20           At step 50, a determination is made as to whether any scenarios s remain to be considered. If the condition is true, the flow of method steps proceeds to step 30 at which the next scenario s is selected for consideration, and steps 34 through 50 are performed again for the selected scenario s. If the condition is false, the flow of method steps proceeds to step 54, at which the summed risk values and their associated probabilities are outputted, and the method terminates. Often this method will be performed at many different times T.

30           Figure 4 shows a possible output of the process of Figure 3, namely a distribution plot of portfolio P's monetary value versus its probability of occurring. Such a distribution is then analyzed by the user to determine a variety of risk-related measures such as Value-at-Risk (VaR) (i.e. the loss that is likely to be exceeded with a specified probability) or

other risk metrics.

The assignee of the present invention has developed a system, framework and methodology for determining and analyzing risk, that attempts to address the deficiencies in prior art risk management systems and methods. This development is referred to herein as the Mark-to-Future (MtF) framework, and is described in U.S. Patent Application 09/323,680, the contents of which are incorporated herein by reference.

Referring to Figure 5, at the foundation of the MtF framework is the generation of a three-dimensional MtF cube consisting of a series of MtF tables. Each MtF table has dimensions  $S_t \times N$ , where  $S_t$  is the number of possible future scenarios under consideration and  $N$  is the number of instruments. In variant embodiments of the invention, the number of scenarios  $S_t$  may vary over a series of time steps (as denoted by the subscript). In the preferred embodiment of the invention, however, we assume that the number of scenarios per time step is constant. While in the preferred embodiment the MtF cube comprises three physical dimensions, there can be many more logical dimensions, and in variant embodiments of the invention, the MtF cube can comprise any number of physical or logical dimensions.

Each MtF table is associated with a given time step  $t$  over an overall time horizon of  $T$  steps. A pre-computed MtF Cube provides a basis onto which the mapping of all financial products and all positions in those products can be accommodated, thereby enabling the full characterization of future portfolio distributions for multiple types of portfolios through time.

Each cell in the MtF Cube contains a simulated expected value (the MtF Value) of a given instrument under a given possible future scenario and time step. These simulated values incorporate different types of risk, including market, credit, and liquidity risks. This is possible since

these various types of risks and the correlation between these various types of risks are embodied in the scenarios that make up the data in the MtF cube 120. The values in the MtF cube 120 inherently may also incorporate the dynamic nature of portfolios, such as the effects of cash settlement or active trading strategies. In certain applications, other sensitivity measures such as an instrument's delta or its duration, for example, may be included in addition to the MtF value. Therefore, in the general case, each cell of a MtF Cube 120 may contain a vector of risk factor dependent measures for a given instrument under a given scenario and time step. In other variant embodiments of the MtF framework, the vector may also contain a set of risk factor dependent cashflows for each scenario and time step.

The MtF framework, and in particular the MtF cube 120 and the data contained in the MtF cube 120, provide a foundation for a wide variety of means for assessing risk and reward associated with a portfolio.

Referring now to Figure 6, a block diagram of a computer system is shown generally as 200. A brief discussion of system 200 is provided so that the reader may understand the utility of the present invention in the context of system 200, in which it is contained.

System 200 can be implemented as part of the MtF framework. This framework is supported by a distributed component based architecture. This architecture, which we refer to as the Mark-to-Future architecture, provides an open scalable system with well-defined system interfaces that enable integration with existing systems while also allowing system 200 to evolve.

A traditional risk framework takes a portfolio and position information as input to a scenario analysis. In contrast, system 200 includes only the instrument detail and delays the aggregation of the results into various portfolio hierarchies until after the scenario analysis. The result of the scenario analysis is the MtF cube 120 which holds the value of each instrument under each scenario and time point.

Risk Engine 202 (e.g. Algorithmics' Algo Risk Engine)

004247"005BT260

performs risk processing to produce market, liquidity, and credit risk measurements. The method of the present invention can be performed by Risk Engine 202. The present invention resides in Risk Engine 202. Risk Engine 202 combines the results calculated by RiskWatch 208 and stored in  
5 MtF cube 120 with data from risk controlling system (RICOS) 204 to produce a requested risk measurement. In the case of exposure calculations, Risk Engine 202 considers account credit mitigation approaches such as, for example, netting hierarchies, credit mitigation portfolios, and credit-to-close.

10               RICOS 204 is a limits management component enabling both overnight and real-time limits assessment. RICOS comprises input data components, a limits server, and a graphical interface which is used for limits configuration and management. Limits management capability includes the ability to create, modify, and remove time varying limits, deal  
15 reservation capability, and limits cascading. Within RICOS 204, a RICOS consolidation cube (not shown) is the key data structure for exposure consolidation and limits management. The consolidation cube consists of different dimensions: risk-taker, risk-on, and product group. Each intersection of the consolidation cube is a consolidation point at which  
20 multiple limits types can be stored and checked. Inputs to RICOS 204 may comprise, for example: credit data (e.g. netting hierarchies, credit states, transition matrices, etc.), limit structures and exposure profiles via Risk Engine 202.

                  The component managing pre-deal capabilities is the Pre-Deal  
25 Server (PDS) 206. PDS 206 is a full transaction system which is an XML-based product capable of supporting multiple languages (i.e. a protocol enabling e-commerce activities in the field of financial derivatives). PDS 206 supports requests for the following analyses, for example:

- 30               a) Pre-deal assessment with Mark-to-Market (MtM) plus add-on calculated exposures;
- b) Pre-deal assessment using full simulation based exposures; and



- c) Pre-deal limits checking with MtM plus add-on calculated exposures.

The resulting pre-deal analysis is configurable, ranging from a simple go/no-go result to a graphical display of the exposure profile through time. Pre-deal assessment evaluates the change in exposure if a user chooses to proceed with the transaction. Pre-deal limits checking extends the assessment by determining the impact to the limits structure. There are two primary methods for computing exposure: Mark-to-Market plus add-on (i.e. plus a spread), and full simulation. With Mark-to-Market plus add-on, the potential future exposure is estimated using a simple, computationally inexpensive look-up of an add-on amount. The add-ons can either be static, as defined in the Bank of International Settlement (BIS) methodology for example, or dynamic, in which case, the add-on factors are frequently recalculated by RiskWatch 208 to reflect the current state of the market risk factors that drive the exposure profile of the portfolio. Full simulation calculates the exposure using the more computationally expensive full simulation approach. In this case, RiskWatch 208 calculates a MtF cube 120 representing the value of the deal for each scenario and time point, and Risk Engine 202 combines the result with the rest of the portfolio.

RiskWatch 208 provides a set of methodologies to aggregate, simulate, measure, restructure and manage both credit and market risk. RiskWatch 208 has been designed as the modeling engine in a comprehensive risk management framework for not only meeting Bank of International Settlement (BIS) guidelines, but also for active risk management and capital allocation. RiskWatch 208 creates the MtF cube 120 by revaluing a set of instruments for each scenario and each time point. RiskWatch 208 receives input such as, for example: treasury products, financial models, and scenarios from HistoRisk 210 described below.

HistoRisk 210 is a scenario generator which provides the scenario sets to RiskWatch 208 in order for RiskWatch 208 to compute

values of the MtF cube 120. HistoRisk 210 implements many scenario generation techniques such as:

- a) standard Monte Carlo scenarios;
- b) multi-step Monte Carlo scenarios, which are required to calculate potential exposures for credit risk,
- c) stratified sampling, which involves separating an underlying distribution into ranges and sampling from each range by its probability; and
- d) Sobol sequences, a form of quasi-Monte Carlo technique, where samples are taken to ensure that they are approximately evenly spaced.

HistoRisk 210 takes as input time series data and outputs scenarios and variance/covariance matrices to RiskWatch 208.

Portfolio Credit Risk Engine (PCRE) 212 is an integrated market and credit risk framework that generates portfolio credit risk analysis including credit Value at Risk (VaR), as well as stress tests, based on the joint distributions of credit migrations across counterparties and market risk factors. PCRE 212 supports the simultaneous incorporation of multiple migration models that may be applicable to different product sectors, such as treasury and commercial banking, across an institution. PCRE 212 takes as input, for example: credit states from RICOS 204, counterparty exposure profiles from Risk Engine 202 and credit state scenarios from HistoRisk 210.

The data required for system 200 is often scattered over other systems, each of which may have a unique data format and data conventions. RiskMapper 214 is designed as a flexible mapping tool that maps data exported from these other systems into an input format suitable for system 200. RiskMapper 214 shields users from the underlying mapping code by providing a simple graphical user interface to define the data mapping rules.

Once source data has been mapped by RiskMapper 214, it is stored in Algo Input Database (AIDB) 216 data server. AIDB 216 comprises

a relational database and set of tools for populating, modifying, and selecting the data for analysis by RiskWatch 208.

Reporting database 218 stores the results of risk measure calculations. These results need to be saved for enterprise reporting.

5 Reporting database 218 is a relational database designed to store the enterprise risk results such as value-at-risk, sensitivities, and exposures, for example. Reporting database 218 forms the basis of a reporting function, including batch oriented reporting as well as interactive adhoc queries.

10 Cube explorer 220 is a graphical user interface that allows interactive analysis of the data in MtF cube 120. Application server 222 hosts cube explorer 220 and a plurality of clients 224 which receive reporting data from system 200.

The flexibility of this MtF framework and its computational  
15 efficiency allows the MtF framework to be applied to a wide range of problems.

For example, in the preferred embodiment of the present invention, the MtF framework is adapted to value a portfolio in terms of its expected downside losses and upside gains under a range of future  
20 scenarios, relative to a chosen benchmark.

Consider the simulation where a portfolio's monetary value is to be determined over a single period. The MtF simulation is performed on a set of basis instruments, over a set of possible future scenarios and an appropriate time horizon. The financial products comprising the portfolio  
25 are mapped to this set of instruments, and the portfolio is mapped to the financial products. The result is a set of MtF values for the portfolio, one for each scenario.

Some of the scenarios will have resulted in gains for the portfolio and some will have resulted in losses. The gains and losses  
30 could be absolute or computed with respect to a benchmark, the benchmark itself being subject to the same simulation.

For example, the chosen benchmark may be a target security

or a portfolio that is to be replicated (e.g., a stock index or an exotic option), an alternative investment (e.g., cash), or a historical portfolio value against which gains and losses are calculated.

If probabilities are associated with each scenario (that is, the probability of each scenario occurring), a distribution of unrealized gains (i.e. the portfolio's "upside") and a distribution of unrealized losses (i.e. the portfolio's "downside") relative to the benchmark can be obtained. Referring to Figure 7a, if the portfolio's value exceeds that of the chosen benchmark in a given scenario, then the difference between their values is an unrealized gain and contributes to the portfolio's upside. Conversely, if the value of the chosen benchmark exceeds that of the portfolio in a given scenario, then the difference between their values is an unrealized loss and contributes to the portfolio's downside.

Referring to Figure 7b, it can be shown that the portfolio's upside has the same payoffs as a European call option, with strike equal to the benchmark value, and with a maturity equal to the horizon. Similarly, referring to Figure 7c, it can be shown that the portfolio's downside has the same payoff as a short position in a European put option, with strike equal to the benchmark value, and with a maturity equal to the horizon. Thus, according to the present invention, a portfolio can be valued in terms of its possible future upside and downside payoffs: the risk and reward associated with the portfolio can be calculated by placing a value on the put option and call option respectively. The interpretation of a portfolio's possible future upside and downside payoffs in the context of put and call options allows investors to assess the trade-off between the risk and reward of a portfolio in a simpler, more intuitive manner.

Furthermore, this is an inherently forward-looking view of risk and reward since the value of the put or call option is dependent exclusively on future events, although the past might influence the choice of scenarios. It is also easy to evaluate multiple choices for the scenario probability weights under the MtF framework.

We now discuss different applications where a portfolio's upside and downside can be used in the managing of risk associated with portfolios.

A. Measurement and Ranking of Portfolios

5                   Many risk or reward measures can be derived from the distribution of computed unrealized gains or losses. For example, the VaR measure for a portfolio can be calculated as a specified percentile of the downside, using the mark-to-market value of the portfolio as the benchmark. Other measures may include expected shortfall and standard  
10 deviation, for example.

                  In the preferred embodiment of the invention, a Put Value of a portfolio is calculated by determining the expected downside loss associated with the portfolio under the range of possible future scenarios. This represents one method of valuing the put option and takes into  
15 account the probabilities of scenarios occurring.

                  Similarly, a Call Value of a portfolio is calculated by determining the expected upside gain associated with the portfolio under the range of possible future scenarios. This represents one method of valuing the call option and takes into account the probabilities of scenarios  
20 occurring.

                  In variant embodiments of the invention, the Put Value of a portfolio may alternatively be calculated by determining the maximum downside gain or some other measure related to the downside associated with the portfolio given a set of possible future scenarios and probabilities  
25 of each scenario occurring. Similarly, the Call Value of a portfolio may alternatively be calculated by determining the maximum upside gain or some other measure related to the upside associated with the portfolio given a set of possible future scenarios and probabilities of each scenario occurring. In variant embodiments of the invention, the Put Value and  
30 Call Value of a portfolio may be calculated based on a single future scenario.

00427" 00527260

The Put and Call values of an existing portfolio can be used to obtain a risk/reward performance measure for the portfolio, relative to a benchmark. In so doing, the Put Value is essentially used as a risk measure associated with the future performance of the portfolio (rather than variance of expected returns as is known, for example) and the Call Value is used as a reward measure associated with the future performance of the portfolio (rather than expected return as is known, for example). A risk/reward performance measure that incorporates a Put Value and/or a Call Value may be evaluated for each of a set of portfolios or each of a set of instruments (for example, a set of mutual funds, or a set of individual securities). The resultant performance measures can then be compared permitting the portfolios or the instruments in the set to be ranked. Any function of Call Value, Put Value, or both may be used in obtaining a performance measure. Some possible performance measures include, for example:  $\text{Call} - \lambda(\text{Put})$  (where  $\lambda$  is given a specified value) and  $\text{Call}/\text{Put}$ .

#### B. Constructing Efficient Portfolios (Optimization Model)

Given a performance measure (or an investor's utility function in the context of the discussion below), one can formulate an optimization model to find the portfolio that obtains a best possible score according to the performance measure used. In this case, there is no single existing portfolio that is to be evaluated, only a set of constraints that define feasible portfolios.

One approach to this optimization problem is to construct an efficient frontier, and to then use utility theory to select an efficient portfolio.

The trade-off between risk and reward can be interpreted as a trade-off between the expected downside and the expected upside of a portfolio in the context of the present invention. An efficient portfolio can be defined as a portfolio which maximizes the expected upside for a given amount of expected downside. The upside and downside, as

5

The Put/Call Efficient Frontier is defined by the solution to:

10

15

20

25

For each value of  $k$ , the solution to Problem 1 is obtained and multiple portfolios are evaluated for which the largest possible expected upside while not incurring more than  $k$  units of expected downside are

calculated. As the problem is solved for further values of  $k$ , as  $k$  is increased from zero, the optimal solution values define the Put/Call Efficient Frontier.

In a variant embodiment of the invention, the Put/Call  
5 Efficient Frontier may be alternatively constructed by minimizing the Put Value subject to obtaining a specified level of Call Value.

The generation of the Put/Call Efficient Frontier requires a linear program to be solved, which is mathematically formulated below.

Suppose there are  $n$  securities, indexed by  $i$ , available for  
10 constructing a portfolio. Possible states-of-the-world at a time step  $t$  are represented by  $s$  scenarios, indexed by  $j$ . We assume that the benchmark is a security which grows in value at a specified rate in each scenario. For example, one could choose a risk-free security as the benchmark and set the growth rates in all scenarios to be consistent with the risk-free rate. By  
15 incorporating the benchmark in terms of a set of growth rates, the subject invention does not require an explicit normalization constraint for scaling purposes.

In the preferred embodiment of the invention, different tranches of the same security are considered to be separate instruments.  
20 For example, suppose a particular stock trades at one price for up to 10,000 shares and another price for over 10,000 shares (the liquidity premium), then these two tranches of the stock are considered to be two distinct instruments in the optimization model.

One unit of security  $i$ , which is currently worth  $q_i$ ,  $q_i$  being the  
25 current mark-to-market value of security  $i$ , attains a Mark-to-Future value of  $M_{ji}$  in scenario  $j$ . Likewise, an investment of  $q_i$  in the benchmark yields a value of  $r_j q_i$  in scenario  $j$ . For example, a benchmark growth rate of  $r_j > 1$  means that the benchmark appreciates in value.

A portfolio that consists of positions  $x_i$  in each security  $i$   
30 achieves an upside gain, relative to the benchmark, of:



$$u_j = \max \left[ \sum_{i=1}^n (M_{ji} - r_j q_i) x_i, 0 \right]$$

and a downside loss, relative to the benchmark, of:

$$d_j = \max \left[ \sum_{i=1}^n (r_j q_i - M_{ji}) x_i, 0 \right]$$

in scenario  $j$ . Note that the equation

$$u - d = (M - r q^T) x \quad (1)$$

together with the conditions

$$\begin{aligned} u &\geq 0 \\ d &\geq 0 \\ u^T d &= 0 \end{aligned}$$

correctly specifies the upside and downside across all scenarios. In this specification, equation (1) is referred to as the tracking constraint, and  $u^T d = 0$  is referred to as the complementarity constraint.

To simplify the notation, we define the net gain that results from holding one unit of security  $i$  instead of the benchmark in scenario  $j$  to be

$$V_{ji} = M_{ji} - r_j q_i$$

and, more generally,

$$V = M - r q^T$$

Thus, Equation 1 can be written equivalently as

$$u - d = V x$$

In practice, there may be limits on the sizes of trades that can be executed, or on the price that can be obtained for a particular trade volume. In other words, markets are said to possess finite liquidity. To model finite liquidity, we place limits on the position sizes and assume

that the price of a security is an increasing, piecewise constant function of volume as is shown in Figure 8a. The latter restriction reflects the fact that there is a cost, or a liquidity premium, associated with trading increasingly large quantities of a given security.

5 Referring to Figure 8a, up to  $x_b$  units of a given security can be sold at a given price while additional units, up to a maximum of  $x_d$ , can only be sold at a lower price; the first  $x_c$  units can be bought at a given price and additional units, up to a maximum of  $x_e$ , demand increasingly higher prices.

10 Referring to Figure 8b, the corresponding total cost function, which plots the cost of trading a given quantity of the security, is piecewise- linear and convex.

This representation allows a security to be decomposed into a series of tranches, each with its own constant price and trading limits, that  
15 reflect the actual price/volume behaviour of the security. Each tranche is then modeled as a separate security. For example, the security represented in Figure 8a consists of five tranches with the following trading limits:

$$\begin{aligned} (x_a - x_b) &\leq x_1 \leq 0 \\ x_b &\leq x_2 \leq 0 \\ 20 \quad 0 &\leq x_3 \leq x_c \\ 0 &\leq x_4 \leq (x_d - x_c) \\ 0 &\leq x_5 \leq (x_e - x_d) \end{aligned}$$

A position,  $x$ , in the security is simply the sum of the positions in the individual tranches:

$$25 \quad x = x_1 + x_2 + x_3 + x_4 + x_5 \quad (2)$$

More generally, we denote the collective set of lower and upper trading limits for all securities by  $x_L$  and  $x_U$ , respectively. By definition,  $(x_U)_i = 0$



Note that Problem 2 does not contain the complementarity constraint  $u^T d = 0$ . This constraint can be safely omitted when constructing the Put/Call Efficient Frontier for risk-averse investors.

Solving the linear program above defines one point on the Put/Call Efficient Frontier. Generation of the entire Put/Call Efficient Frontier requires the linear program to be solved for all  $k \geq 0$ .

Constructing the efficient frontier exactly typically requires the use of parametric programming since  $k$  is a continuous variable. Alternatively, one can solve Problem 2 for a finite set of  $k$  values and then obtain an approximate efficient frontier by interpolating (e.g. linearly) between the optimal solutions. The resulting approximation can be made more precise by solving the problem for additional intermediate values of  $k$ .

Referring to Figure 9, it is evident that the resultant Put/Call Efficient Frontier is concave and piecewise-linear.

In the present invention, an efficient portfolio may now be selected based on expected utility. The Put/Call Efficient Frontier, if it is non-degenerate, identifies an infinite number of efficient portfolios, each providing the maximum amount of expected upside for a given level of expected downside. The selection of a particular efficient portfolio depends on an investor's risk/reward preferences and absolute tolerance level for risk, as measured by the expected downside. Note that by definition, any portfolio not on the Put/Call Efficient Frontier is dominated by an efficient portfolio and will never be selected by an investor.

In the preferred embodiment of the invention, it is assumed that investor will act in a manner that maximizes the value of:

$$\text{expected utility} = (\text{expected upside}) - \lambda(\text{expected downside})$$

where  $\lambda \geq 0$  is a constant representing the investor's degree of risk aversion. Variant embodiments of the invention may incorporate

different utility functions or performance measures.

An investor who is highly averse to risk will have a large  $\lambda$ , while an investor who is keen to take risks will have a small  $\lambda$ . In general, we refer to investors as being risk-averse ( $\lambda > 1$ ), risk-neutral ( $\lambda = 1$ ) or risk-seeking ( $0 \leq \lambda < 1$ ). The above equation for expected utility is consistent with a utility function that is bi-linear in gains and losses (relative to the benchmark).

For an efficient portfolio,  $\mu$  measures the marginal expected upside per unit of expected downside. If the amount of risk that can be tolerated is unlimited, then an investor with risk aversion  $\lambda_0$  will select an efficient portfolio with  $\mu = \lambda_0$  or, if there is no such portfolio, an efficient portfolio with  $\mu > \lambda_0$  and the largest expected upside (or, alternatively,  $\mu < \lambda_0$  and the smallest expected upside).

Viewed geometrically, an investor will select the portfolio defined by the point at which a line with slope  $\lambda_0$  is tangent to (or more precisely, is a subgradient of) the Put/Call Efficient Frontier.

Referring to Figure 11, for example, an investor with risk aversion  $\mu_1 < \lambda_0 < \mu_2$  will select the portfolio that corresponds to point A on the Put/Call Efficient Frontier. An investor with  $\lambda_0 = \mu_1$  will be indifferent among all portfolios on the segment from the origin to point A, while an investor with  $\lambda_0 = \mu_2$  will be indifferent among all portfolios on the segment between points A and B.

If we restrict our attention to risk-averse investors, it follows that only those segments of the Put/Call Efficient Frontier having slope greater than one are relevant for decision-making purposes. The corresponding efficient portfolios automatically satisfy the complementarity constraint in this case.

However, selecting portfolios based on a bi-linear utility

004227-00527260

function ignores the fact that there is typically an upper limit on the amount that an investor is prepared to lose (in this context, loss is equivalent to the expected downside relative to a benchmark). For example, while a loss of \$50,000 may bankrupt an individual investor, a corporation may be able to withstand losing several million dollars without any adverse effect. Thus, if we are to consider a restriction reflecting an allowable maximum loss, investors will effectively be restricted to portfolios on a truncated Put/Call Efficient Frontier that extends from an expected downside of zero up to some level  $k_o$ , which corresponds to the maximum loss that can be tolerated.

In contrast to Figure 11, the example of Figure 12 shows that an investor with risk aversion  $\lambda_o$ , where  $\mu_1 < \lambda_o < \mu_2$ , and maximum loss tolerance  $k_o$ , where  $k_o < k_A$ , will be forced to select the portfolio that corresponds to point C, rather than A, on the Put/Call Efficient Frontier. In this case, the maximum loss tolerance level causes the investor to act in a manner that is consistent with an implied risk aversion of  $\mu_1$  rather than  $\lambda_o$ .

Referring to Figure 13, a method of the present invention relating to the selection of efficient portfolios commences at step 240.

Step 242 requires that a portfolio whose data is stored in a MtF cube 120 of Figures 5 and 6, be decomposed into its downside losses and upside gains. The decomposition of a portfolio is performed as part of solving the optimization problem. Note that it is not the case that all possible portfolios are decomposed "up front".

At step 244, a Put/Call Efficient Frontier is constructed by solving, using an optimization software package as is known in the art, the linear program as outlined in the mathematical formulation previously described in this specification.

At step 246, an efficient portfolio is selected based on expected utility specified by a given value, or alternatively, based on expected utility specified by a first given value and based on a maximum loss tolerance

specified by a second given value.

At step 248, data corresponding to the selected efficient portfolio may subsequently be outputted or stored. The flow of method steps then proceeds to step 250, where the method is terminated.

- 5           In variant embodiments of the invention, another approach to determining the portfolio that obtains the best possible score given a performance measure (alternatively put, the highest utility given an investor's utility function) can be used by incorporating the utility function directly into the optimization model and solving a single  
10 mathematical program. For example, solving a linear program that maximizes the value of the utility function  $Call-\lambda(Put)$  for a specified value of  $\lambda$  will define an efficient portfolio. This differs from the previous approach described where an efficient frontier defining numerous portfolios that trade off Put and Call Values is constructed, and whereafter  
15 an efficient portfolio is selected for a given  $\lambda$ .

#### C. Pricing Portfolio Insurance for Arbitrary Portfolios

As a by-product of the optimization model, one can use duality theory, as is known, to price any instrument for which we have a set of Mark-to-Future values.

- 20           In particular, one can price an instrument whose payoff matches the downside of a given portfolio under a range of possible future scenarios. In other words, the payoff must equal the downside in exactly those scenarios in which the portfolio incurs downside, and be zero in all upside scenarios (i.e., the insurance exactly offsets losses, and does not pay  
25 out otherwise). Thus, given an arbitrary portfolio, the upside and downside payoffs associated with that portfolio can be determined, and subsequently, one can properly price portfolio insurance that will insure an investor against the downside.

- 30           The price of the portfolio insurance is not unique, and will depend on the risk preferences of individual investors. The price is correct

00421T 0058T 260

for an investor who makes decisions based on the performance measure (or utility function) used in the optimization model.

5 The information necessary to price portfolio insurance is inferred from the problem that is dual to Problem 2. In a manner similar to arbitrage-free pricing, it is possible to derive a set of benchmark-neutral probabilities and infinite-liquidity prices that exactly balance the expected upside and expected downside of all instruments that are included in the optimization problem (i.e., the  $n$  securities that are available for constructing the portfolio). The benchmark-neutral probabilities can then  
10 be used to obtain prices for new securities that are consistent with an optimal portfolio. A new security is one that was not included in the optimization problem. Given its MtF payoffs, we can calculate the price at which the investor will be indifferent to trading this security; i.e. it is the price at which the investor will have no incentive to either buy or sell the  
15 security in order to improve the optimal portfolio (i.e., to obtain a portfolio with higher utility). Suppose an investor with risk aversion  $\lambda=1.5$  solves the optimization problem and obtains an optimal portfolio with utility 100 (note that this utility depends on the investor's  $\lambda$ ). Afterwards, a new company stock gets issued and it is marked-to-future.  
20 We can calculate the price for this stock at which it cannot increase the utility of the portfolio beyond 100, so the investor will have no incentive to buy it or short it. This price depends on the investor's  $\lambda$  and on the composition of the optimal portfolio.

25 The mathematical formulation of the relevant problem is described below.

Taking the dual of Problem 2 results in the following linear program (relevant primal variables are listed in parentheses):



Problem 3 (dual problem)

$$\text{minimize}_{(\mu, \pi, \omega_L, \omega_U)} k\mu - (x_L)^T \omega_L + (x_U)^T \omega_U$$

such that

$$\omega_L, \omega_U + (M^T - qr^T)\pi = 0 \quad (x)$$

$$p\mu - \pi \geq 0 \quad (d)$$

$$\pi \geq p \quad (u)$$

$$\mu, \omega_L, \omega_U \geq 0$$

Note that the dual problem always has a feasible solution. For example, setting  $\pi_j = p_j$  for all scenarios  $j$ , and setting

$$(\omega_L)_i = \max \left[ -\sum_{j=1}^s (M_{ji} - q_{ji}r_j)p_j, 0 \right]$$

and

$$(\omega_U)_i = \max \left[ \sum_{j=1}^s (M_{ji} - q_{ji}r_j)p_j, 0 \right]$$

for all securities  $i$ , satisfies the constraints in Problem 3. Thus, Problem 2, the primal problem, is always bounded and the expected upside is always finite for any amount of expected downside (intuitively, this is due to the fact that liquidity is finite; put another way, only a limited amount of each security can be traded).

*Benchmark-neutral probabilities and infinite-liquidity prices*

The dual constraint for security  $i$  is

$$(\omega_L)_i - (\omega_U)_i + \sum_{j=1}^s (M_{ji} - q_{ji}r_j)\pi_j = 0 \quad (3)$$

where  $(\omega_L)_i$  and  $(\omega_U)_i$  are liquidity dual prices. By complementary slackness,  $(\omega_L)_i$  and  $(\omega_U)_i$  will be zero if security  $i$  is strictly between its upper and lower bounds. When there are tranches, it is impossible for all positions to be strictly between their bounds (there cannot be successive  
5 partially-filled tranches) and some elements of  $\omega_L$  or  $\omega_U$  will be positive in this case.

From the weights  $\pi$ , we can define a set of benchmark-neutral probabilities  $\rho$ , where

$$\rho_j = \frac{\pi_j}{f}$$

10 and

$$f = \sum_{i=1}^s \pi_i$$

Dividing Equation 3 by the sum of the weights yields

$$15 \quad \frac{(\omega_L)_i}{f} - \frac{(\omega_U)_i}{f} + \sum_{j=1}^s (M_{ji} - q_i r_j) \rho_j = 0 \quad (4)$$

Now, let

$$E_{\rho}(V_{\omega}) = \sum_{j=1}^s (M_{ji} - q_i r_j) \rho_j \quad (5)$$

denote the expected gain, relative to the benchmark, of one unit of security  $i$  under the probabilities  $\rho$ .

20 From Equations 4 and 5, it follows that

$$E_{\rho}(V_{\omega}) = \frac{(\omega_U)_i}{f} - \frac{(\omega_L)_i}{f} \quad (6)$$

Thus, when  $(\omega_L)_i = (\omega_U)_i = 0$ , the benchmark-neutral probabilities  $p$  satisfy

$$E_p(V_{(i)}) = 0$$

for security  $i$ . The non-zero elements of  $\omega_L$  and  $\omega_U$  reflect liquidity premiums and discounts, respectively, that are inherent in the observed prices of securities.

If security  $i$  is basic in the linear programming sense (all securities that are strictly between their bounds are basic; in the case of degeneracy, securities that are at a bound may also be basic), then the liquidity dual prices  $(\omega_L)_i$  and  $(\omega_U)_i$  are zero. Thus, basic securities obtain a weighted gain of zero relative to the benchmark under the weights  $\pi$ , and it follows that they equally trade off expected upside and expected downside under the benchmark-neutral probabilities  $p$  (i.e.,  $p$  is a Martingale probability measure for the gains of basic securities).

If security  $i$  is at its lower bound, then  $(\omega_L)_i > 0$  (assuming no degeneracy) and, from Equation 6, it follows that  $E_p(V_{(i)}) < 0$ . That is, under the benchmark-neutral probabilities, security  $i$  contributes more expected downside than expected upside. Hence, the size of the position is as small as possible, and will in fact be negative if the security can be shorted. Note that we can express the observed price as

$$q_i = \hat{q}_i + \frac{(\omega_L)_i}{r^T \pi}$$

where  $\hat{q}_i$  is the infinite-liquidity price and  $\frac{(\omega_L)_i}{r^T \pi}$  is a liquidity premium.

Note that  $\hat{q}_i$  is that price for which security  $i$  obtains an expected gain of zero relative to the benchmark under the benchmark-neutral probabilities.

Specifically, there exists a set of gains

$$\hat{V}_{ji} = M_{ji} - r_j \hat{q}_i$$

for which  $E_p(\hat{V}_{(i)}) = 0$ .

- 5 Conversely, if security  $i$  is at its upper bound, then  $(\omega_v)_i > 0$  (assuming no degeneracy) and  $E_p(V_{(i)}) > 0$ . In this case, we can write

$$q_i = \hat{q}_i - \frac{(\omega_v)_i}{r^T \pi}$$

where  $\frac{(\omega_v)_i}{r^T \pi}$  is a liquidity discount and, again,  $E_p(\hat{V}_{(i)}) = 0$ .

- 10 In summary, the liquidity dual prices allow us to obtain infinite-liquidity prices  $\hat{q}$  and a corresponding set of gains  $\hat{V}$  that is a Martingale under  $p$ .

#### *Benchmark-Neutral Pricing*

For any security  $i$ ,

$$15 \quad \hat{q}_i = \frac{1}{r_o} M_{(i)}^T p \quad (7)$$

where

$$r_o = r^T p$$

- Equation 7 represents benchmark-neutral valuation: the infinite-liquidity  
 20 price of a security equals its expected payoff over  $p$ , discounted at the rate  $r_o$ . Note that in the case of a complete, infinitely-liquid market with  $r = 1$  (when the benchmark is the mark-to-market value of the portfolio), Equation 7 is equivalent to risk-neutral valuation. Benchmark-neutral prices, however, exist even when markets are illiquid and/or incomplete  
 25 (although the price does depend on the risk preferences of the investor. Benchmark-neutral pricing is equivalent to the concept of utility-invariant pricing, which finds the price  $q_h$  at which an investor is indifferent to

trading security  $h$  in an optimal portfolio. Observe that an investor holding a portfolio that optimally trades off Put Value and Call Value will be inclined neither to buy nor sell security  $h$  if  $E_p(V_{(h)}) = 0$ , which implies that its infinite-liquidity price satisfies Equation 7.

- 5                   Equation 7 can also be used to price a Put Option and a Call Option by replacing  $M_{(i)}$  with the downside (d) and upside (u) payoffs of the portfolio respectively. Note that put/call parity:

$$r_0 \rho^T u - r_0 \rho^T d = r_0 \rho^T (M - r q^T) x$$

- 10                   is a restatement of the complementary slackness condition for the tracking constraints:

$$\pi^T (u - d - (M - r q^T) x) = 0$$

- 15                   To price portfolio insurance, replace  $M_{(i)}$  is replaced with the downside payoffs of the optimal portfolio. Given an arbitrary set of MtF payoffs, we can calculate a price as described earlier in this specification. This price is only relevant in relation to the optimal portfolio - i.e., it is the price at which the investor will be indifferent to trading the new instrument, given that he or she is currently holding the optimal portfolio. If the set of MtF payoffs happen to match the downside payoffs of the optimal portfolio, then purchasing this "instrument" can be interpreted as buying insurance for the optimal portfolio. The price of this instrument is the maximum amount that the investor would be willing to pay in order to avoid any downside, given that the investor is holding the optimal portfolio. Thus, if the payoffs do not exactly match the downside of the optimal portfolio, a price can still be obtained, but the instrument cannot be interpreted as being insurance, strictly speaking, in this case.
- 20
- 25

### Other Properties of the Put/Call Efficient Frontier

Referring again to Figure 9, the Put/Call Efficient Frontier is concave and piecewise-linear. As the allowable downside  $k$  changes, so do the basic instruments and, hence, also the benchmark-neutral probabilities and the dual prices. Specifically, the benchmark-neutral probabilities and the dual prices change only at discrete points (i.e., when there is a change in the optimal basis of the linear program), and thus they are effectively step functions, rather than linear functions, of  $k$  (they are of the same general form as the function shown in Figure 8a). To be precise, when referring to these values in the context of the Put/Call Efficient Frontier, it is necessary to define them as explicit functions of  $k$  (i.e.,  $\rho(k)$ ,  $\omega_L(k)$ ,  $\omega_U(k)$ ,  $\mu(k)$ ). However, to simplify the notation, we continue to use our existing convention, with the implicit understanding that the values are consistent with the currently-specified limit for expected downside.

Since the primal and dual objective functions are equal at optimality, it follows from Problems 2 and 3 that for each  $k$ , an efficient portfolio satisfies

$$\rho^T u = k\mu - (x_L)^T \omega_L + (x_U)^T \omega_U \quad (8)$$

Note that in Equation 8,  $\mu$ ,  $\omega_L$  and  $\omega_U$  are actually step functions that depend on  $k$ . Thus, over each range of  $k$  values that leaves the basic securities unchanged, the expected upside is a linear function of the expected downside (i.e.,  $\rho^T u = k\mu + \theta$ , for some constant  $\theta$ ) and so the Put/Call Efficient Frontier is piecewise linear. The slope of the Put/Call Efficient Frontier at the point  $k$  equals  $\mu$ , the marginal expected upside per unit of expected downside. Note that  $\mu$  decreases with increasing  $k$  and so the Put/Call Efficient Frontier is concave. Intuitively, this occurs because the most attractive opportunities for trading off expected upside and expected downside are used first; as  $k$  increases, and the most attractive

securities attain their bounds, the marginal expected upside per unit of expected downside ( $\mu$ ) decreases. In contrast, if there are no liquidity constraints (i.e., liquidity is infinite) then, in the absence of arbitrage, the Put/Call Efficient Frontier is a straight line.

5           Equation 8 also indicates that positive expected upside may be attained when  $k = 0$ , as shown in Figure 10. This can occur if the tranches nearest to the zero position provide an arbitrage opportunity, which can be exploited until the corresponding securities reach their trading limits. Thus, the Put/Call Efficient Frontier may terminate at a non-zero value on  
10 the expected upside axis, rather than at the origin.

          The dual problem (Problem 3) includes the constraints  $p \leq \pi \leq \mu p$ . Thus, it follows that  $\mu \geq 1$  and the slope of the Put/Call Efficient Frontier is never less than one (i.e., it is always possible to obtain at least one unit of expected upside per unit of expected downside). This is  
15 due to omitting the complementarity constraint in Problem 2; if both upside and downside can be positive in the same scenario, then one can always trade off equal amounts of Put Value and Call Value on a marginal basis (resulting in  $\mu = 1$ ). Conversely, if  $\mu > 1$ , then it can never be the case that both upside and downside are positive in the same scenario (i.e., the  
20 complementarity constraint is automatically satisfied when  $\mu > 1$ ). Only portfolios with  $\mu > 1$  are relevant for risk-averse investors, which allows the complementarity constraint to be omitted in this case.

#### *The benchmark-neutral Put/Call Efficient Frontier*

          Recall that the benchmark-neutral probabilities and infinite-liquidity prices vary with  $k$  (there is a separate set of values for each  
25 segment of the Put/Call Efficient Frontier). As shown below, solving the primal problem with any set of benchmark-neutral probabilities together with their corresponding infinite-liquidity prices produces a benchmark-neutral Put/Call Efficient Frontier that is a 45-degree line rooted at the  
30 origin.

Let  $\rho$  and  $\hat{q}$  denote a set of benchmark-neutral probabilities and infinite-liquidity prices, respectively. It can be shown from the equations in the previous section that:

$$5 \quad \hat{q} = q + \frac{1}{r^T \pi} (\omega_U - \omega_L)$$

and from the primal problem (Problem 2), it can be shown that

$$\rho^T u = \rho^T d + \rho^T (M - r \hat{q}^T) x$$

10 Substituting this equation into the preceding equation, and using the definition of  $\rho$ , yields

$$\rho^T u = \rho^T d + [(M^T - r^T q) \pi + \omega_U - \omega_L]^T x$$

Since a dual feasible solution satisfies

$$(M^T - r^T q) \pi + \omega_U - \omega_L = 0$$

it follows that:

$$15 \quad \rho^T u = \rho^T d$$

20 Thus, under benchmark-neutral probabilities and infinite liquidity prices, the expected upside equals the expected downside for all portfolios, regardless of the positions taken in the securities. It follows that the Put/Call Efficient Frontier is a 45-degree line rooted at the origin in this case.

It will be apparent to those skilled in the art that the term "value" as used in this specification and in the claims is not limited to



reference to a monetary value.

As will be apparent to those skilled in the art, other various modifications and adaptations of the methods described herein are possible with departing from the present invention, the scope of which is  
5 defined in the claims.

004227-00537260

**WE CLAIM:**

1. A method of valuing a portfolio relative to other portfolios, the method comprising:
  - 5 (a) calculating the overperformance of a portfolio relative to said benchmark under each of a plurality of scenarios to obtain a first plurality of values;
  - (b) calculating the underperformance of said portfolio relative to a benchmark under each of said plurality of scenarios to obtain a second plurality of values;
  - 10 (c) calculating a third value, said third value being a function of said first plurality of values;
  - (d) calculating a fourth value, said fourth value being a function of said second plurality of values; and
  - 15 (e) calculating a fifth value, said fifth value being a measure indicating the desirability of said portfolio, said fifth value being one of:  
a function of said third value; a function of said fourth value;  
a function of said third and fourth values.
- 20 2. The method as claimed in claim 1, wherein said third value is one of: the maximum value of said first plurality of values; the mean of said first plurality of values; the median of said first plurality of values.
- 25 3. The method as claimed in claim 1, wherein said fourth value is one of: the maximum value of said first plurality of values; the mean of said first plurality of values; the median of said first plurality of values.
4. The method as claimed in claim 1, wherein each scenario of said plurality of scenarios is associated with a probability of future

- 39 -

occurrence.

5. The method as claimed in claim 4, wherein said third value is one of: the maximum values of said first plurality of values; the expected value of said first plurality of values; the value associated with the scenario having the highest probability of future occurrence; the value associated with the scenario having the lowest probability of future occurrence.
6. The method as claimed in claim 4, wherein said fourth value is one of: the maximum values of said first plurality of values; the expected value of said first plurality of values; the value associated with the scenario having the highest probability of future occurrence; the value associated with the scenario having the lowest probability of future occurrence.
7. The method as claimed in claim 1, wherein said fifth value is one of: the third value; the fourth value; the third value divided by the fourth value; the third value subtracted by the fourth value; the third value subtracted by the product of a constant and the fourth value, said constant indicative of a level of risk aversion.
8. A method of ranking portfolios, wherein:
- (a) each of a plurality of portfolios are valued according to the method of claim 1, 2, 3, 4, 5, 6, or 7;
  - (b) the plurality of portfolios are ordered according to the measure indicating the desirability of each portfolio; and
  - (c) a portfolio is selected from the plurality of portfolios ordered in (b).
9. The method as claimed in claim 8, wherein the portfolio selected in (c) has the highest measure of desirability.

- 40 -

10. A method of determining the composition of an optimal portfolio, the method comprising:
- (a) providing a plurality of constraints which define a plurality of portfolios;
  - 5 (b) providing a utility function;
  - (c) determining the composition of a portfolio of said plurality of portfolios wherein said portfolio satisfies said plurality of constraints and said utility function, wherein a first value quantifying the overperformance of said portfolio relative to a benchmark under a plurality of scenarios is maximized in relation to other portfolios in said plurality of portfolios, and wherein a second value quantifying the underperformance of said portfolio relative to said benchmark under said plurality of scenarios does not exceed a specified third value.
  - 10
11. The method as claimed in claim 10, wherein said utility function is maximized, said utility function being dependent on at least one of said first and second values.
12. The method as claimed in claim 11, wherein each scenario in said plurality of scenarios is associated with a probability of future occurrence.
- 20
13. The method as claimed in claim 12, wherein said first value is the expected overperformance of said portfolio under said plurality of scenarios, and wherein said second value is the expected underperformance of said portfolio under said plurality of scenarios.
- 25
14. A method of determining the composition of an optimal portfolio, the method comprising:

004217 00537250

- 41 -

- 5 (a) providing a plurality of constraints which define a plurality of portfolios;
- (b) providing a utility function;
- 10 (c) determining the composition of a portfolio of said plurality of portfolios wherein said portfolio satisfies said plurality of constraints and said utility function, wherein a first value quantifying the underperformance of said portfolio relative to a benchmark under a plurality of scenarios is minimized in relation to other portfolios in said plurality of portfolios, and wherein a second value quantifying the overperformance of said portfolio relative to said benchmark under said plurality of scenarios exceeds a specified third value.
- 15 15. The method as claimed in claim 14, wherein said utility function is maximized, said utility function being dependent on at least one of said first and second values.
- 16 16. The method as claimed in claim 15, wherein each scenario in said plurality of scenarios is associated with a probability of future occurrence.
- 20 17. The method as claimed in claim 16, wherein said first value is the expected underperformance of said portfolio under said plurality of scenarios, and wherein said second value is the expected overperformance of said portfolio under said plurality of scenarios.
- 25 18. A method of determining the composition of an optimal portfolio, the method comprising:
- (a) providing a first set of constraints which define a plurality of portfolios;
- (b) determining the composition of a plurality of efficient

004277 "00587260

- 42 -

- 5 portfolios, wherein each of said efficient portfolios satisfies said plurality of constraints, wherein for each of said efficient portfolios a first value quantifying the overperformance of the efficient portfolio relative to a benchmark under a plurality of scenarios is maximized in relation to other portfolios in said plurality of portfolios and a second value quantifying the underperformance of said efficient portfolio relative to said benchmark under a plurality of scenarios does not exceed a specified third value; and
- 10 (c) selecting an optimal portfolio from said plurality of efficient portfolios that satisfies a utility function.
- 15 19. The method as claimed in claim 18, wherein said utility function which is maximized, said utility function being dependent on at least one of said first value of each of said efficient portfolios and said second value of each of said efficient portfolios.
- 20 20. The method as claimed in claim 19, wherein each scenario in said plurality of scenarios is associated with a probability of future occurrence.
- 21 21. The method as claimed in claim 20, wherein said first value of an efficient portfolio is the expected overperformance of that efficient portfolio under said plurality of scenarios, and wherein said second value of an efficient portfolio is the expected underperformance of that efficient portfolio under said plurality of scenarios.
- 25 22. The method as claimed in claim 18, wherein parametric programming is used to perform step (b).
23. A method of determining the composition of an optimal portfolio, the method comprising:

- 43 -

- 5 (a) providing a first set of constraints which define a plurality of portfolios;
- (b) determining the composition of a plurality of efficient portfolios, wherein each of said efficient portfolios satisfies said plurality of constraints, wherein for each of said efficient portfolios a first value quantifying the underperformance of the efficient portfolio relative to a benchmark under a plurality of scenarios is minimized in relation to other portfolios in said plurality of portfolios and a second value quantifying the overperformance of said efficient portfolio relative to said benchmark under a plurality of scenarios exceeds a specified third value; and
- 10 (c) selecting an optimal portfolio from said plurality of efficient portfolios that satisfies a utility function.
- 15 24. The method as claimed in claim 23, wherein said utility function is maximized, said utility function being dependent on at least one of said first value of each of said efficient portfolios and said second value of each of said efficient portfolios.
- 20 25. The method as claimed in claim 24, wherein each scenario in said plurality of scenarios is associated with a probability of future occurrence.
- 25 26. The method as claimed in claim 25, wherein said first value of an efficient portfolio is the expected underperformance of that efficient portfolio under said plurality of scenarios, and wherein said second value of an efficient portfolio is the expected overperformance of that efficient portfolio under said plurality of scenarios.
27. The method as claimed in claim 23, wherein parametric programming is used to perform step (b).

004217 "00587260

- 44 -

28. A method of pricing portfolio insurance, the method comprising:
- (a) determining an investor's utility;
  - (b) obtaining a price based on said investor's utility for a security whose payoffs match the losses of the portfolio relative to a benchmark under a plurality of scenarios, wherein each of said plurality of scenarios is associated with a probability of future occurrence; and
  - (c) valuing insurance for the portfolio based on said price.
29. The method of pricing portfolio insurance in claim 28, wherein said investor's utility is represented by a function which is to be maximized, said function being dependent on at least one of: a value relating to the overperformance of the portfolio relative to said benchmark under said plurality of scenarios; a value relating to the underperformance of the portfolio relative to said benchmark under said plurality of scenarios.
30. A system for valuing portfolios, said system comprising a risk engine adapted to perform the method as claimed in one or more of claims 1 - 27.
31. A system for pricing portfolio insurance, said system comprising a risk engine adapted to perform the method as claimed in claim 28 or claim 29.



**ABSTRACT**

This invention relates to a system and method for valuing a portfolio in terms of its performance relative to a specified benchmark under a range of future scenarios. In particular, the invention takes a portfolio and calculates two values related to the portfolio: the first value corresponding to an amount by which the value of the portfolio is expected to fall below the value of a benchmark over a given time horizon, and a second value corresponding to an amount by which the value of the portfolio is expected to exceed the value of a benchmark over a given time horizon, in view of the range of different future scenarios. The invention provides a means for determining the portfolio which optimally trades-off these two values, and to evaluate risk/reward performance measures using these two values which can be used to rank instruments, securities or portfolios. The invention also provides a means for pricing portfolio insurance for optimal portfolios.

004217-00531/50

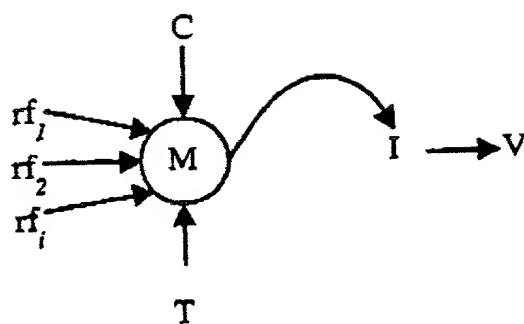


Figure 1

•  
•  
•  
•  
•

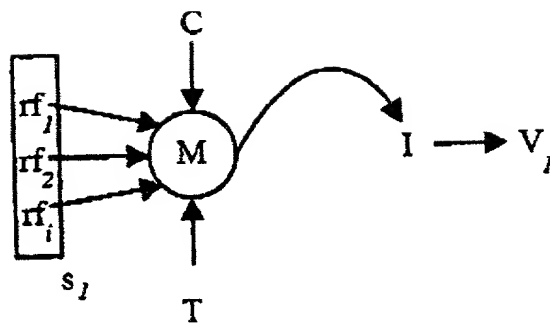


Figure 2

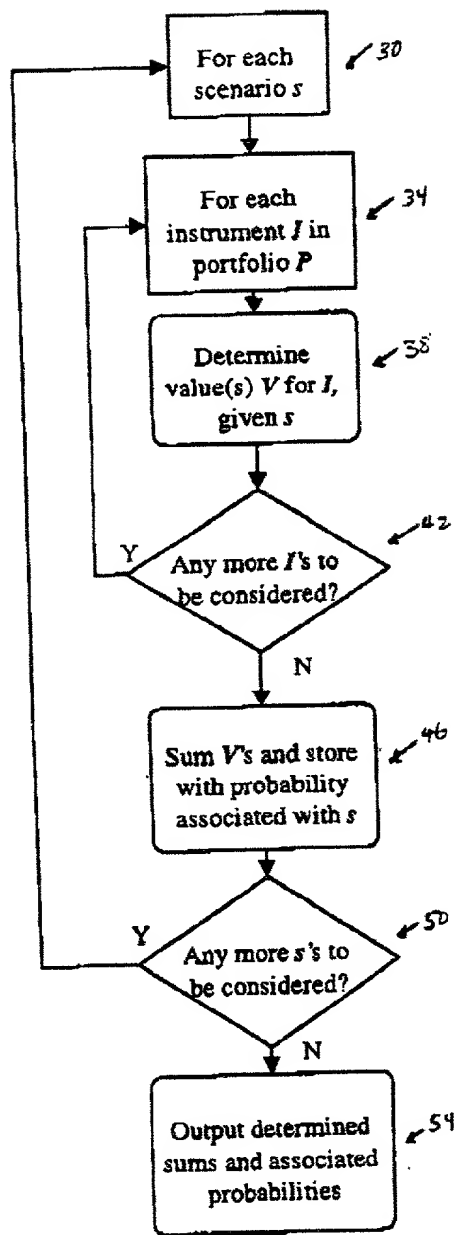


Figure 3

Variable	Mean	SD	Min	Max
Age	35.5	10.5	20	65
Gender	0.5	0.5	0	1
Marital status	0.5	0.5	0	1
Education	12.5	1.5	10	15
Income	15.5	5.5	10	25
Health status	0.5	0.5	0	1
Smoking status	0.5	0.5	0	1
Alcohol consumption	0.5	0.5	0	1
Exercise frequency	0.5	0.5	0	1
Stress level	0.5	0.5	0	1
Sleep quality	0.5	0.5	0	1
Appetite	0.5	0.5	0	1
Weight change	0.5	0.5	0	1
Blood pressure	120	10	90	150
Cholesterol level	180	30	140	220
Blood sugar level	100	10	80	120
Heart rate	70	10	60	90
Respiratory rate	15	5	10	20
Oxygen saturation	95	5	90	100
Temperature	37	0.5	36	38
Heart rate variability	50	10	40	60
Heart rate recovery	100	20	80	120
Heart rate reserve	100	20	80	120
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	1
Heart rate variability index	0.5	0.5	0	1
Heart rate recovery index	0.5	0.5	0	1
Heart rate reserve index	0.5	0.5	0	



Figure 4

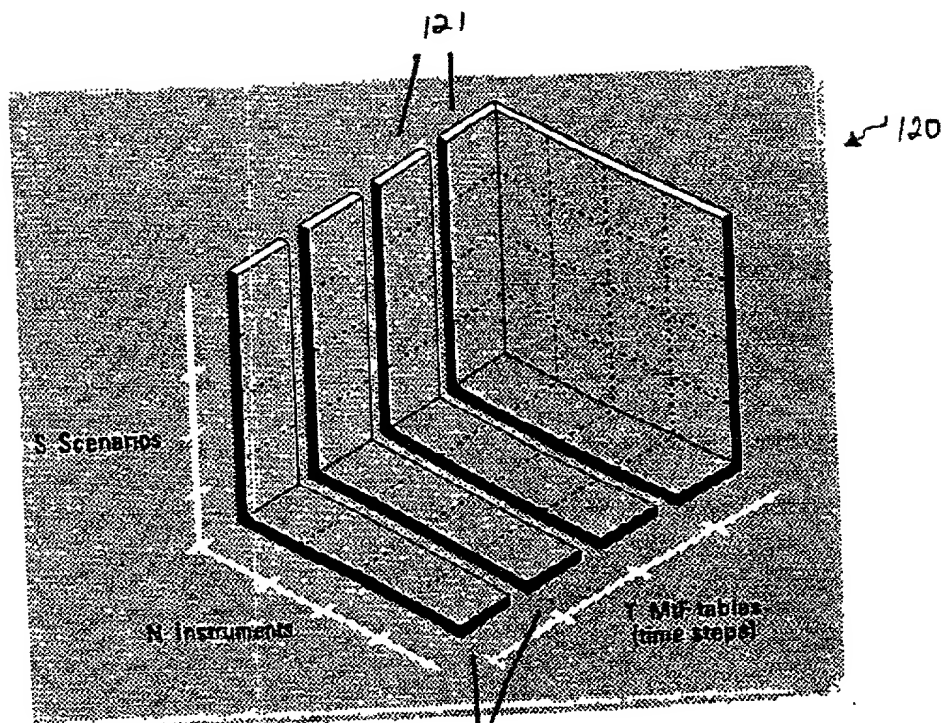
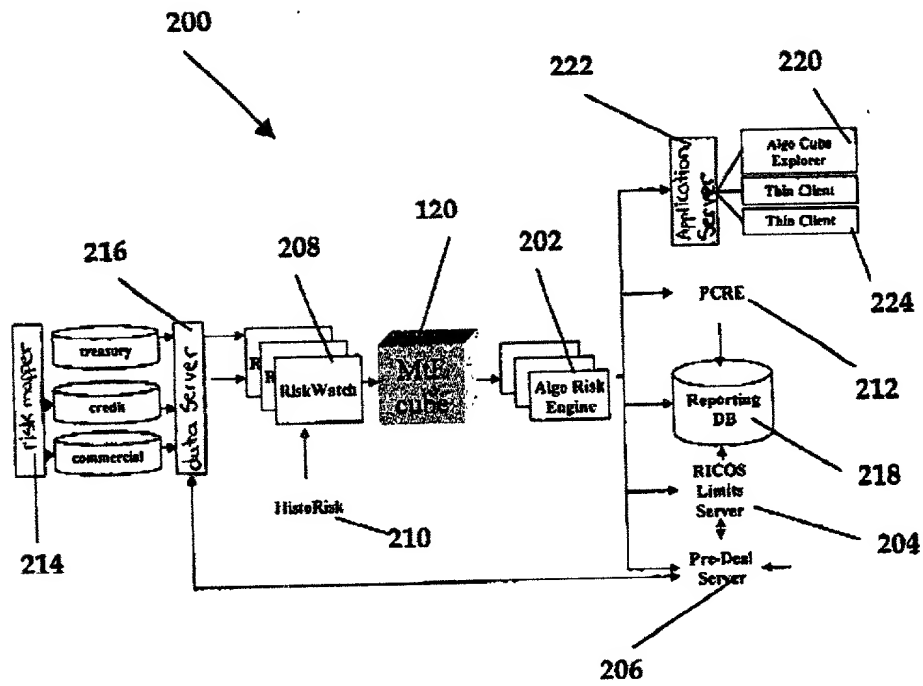


Figure 5

121

FIG. 6



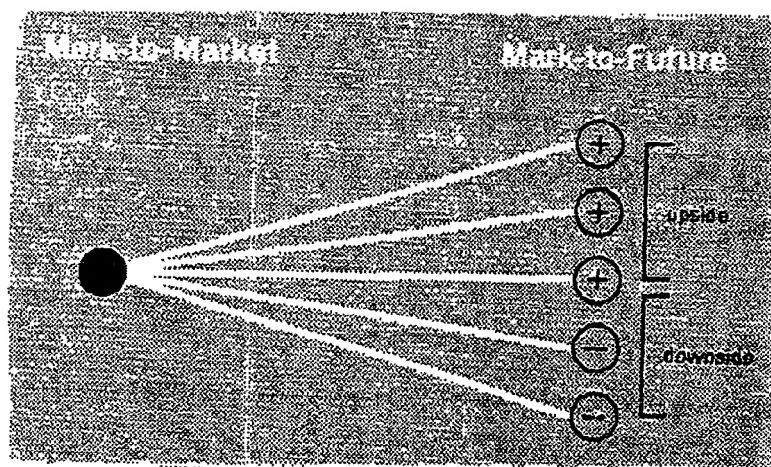


Figure 7a



Figure 7b

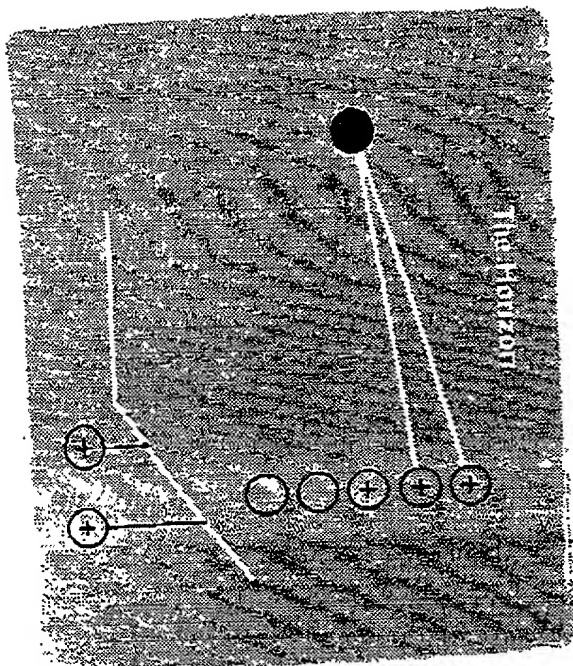
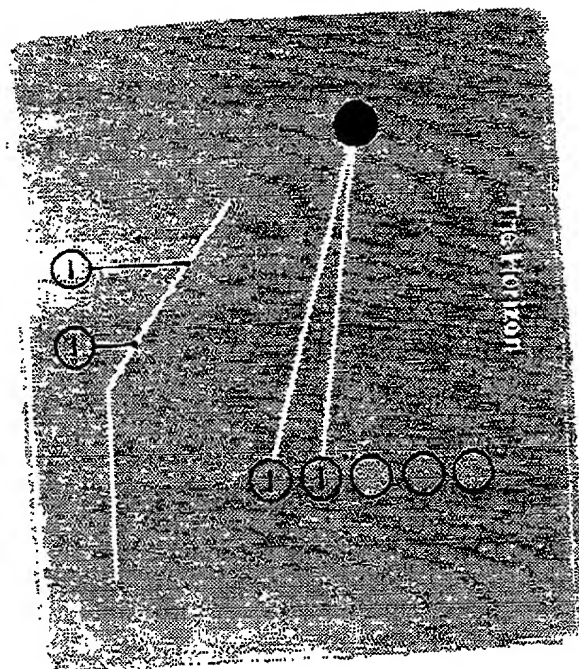


Figure 7c



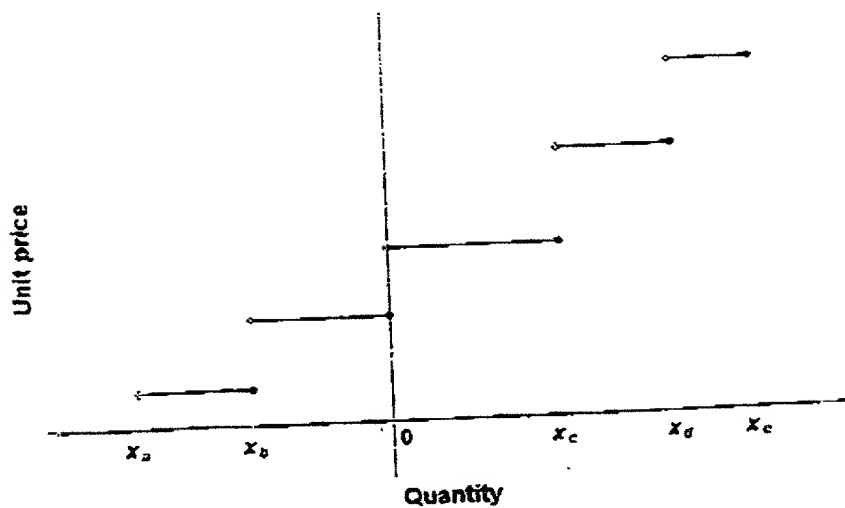


Figure 8a

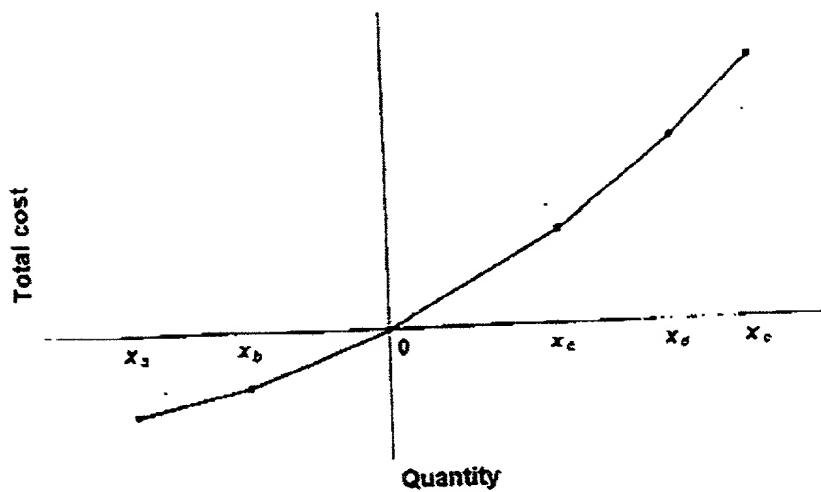


Figure 8b

004427-00531260

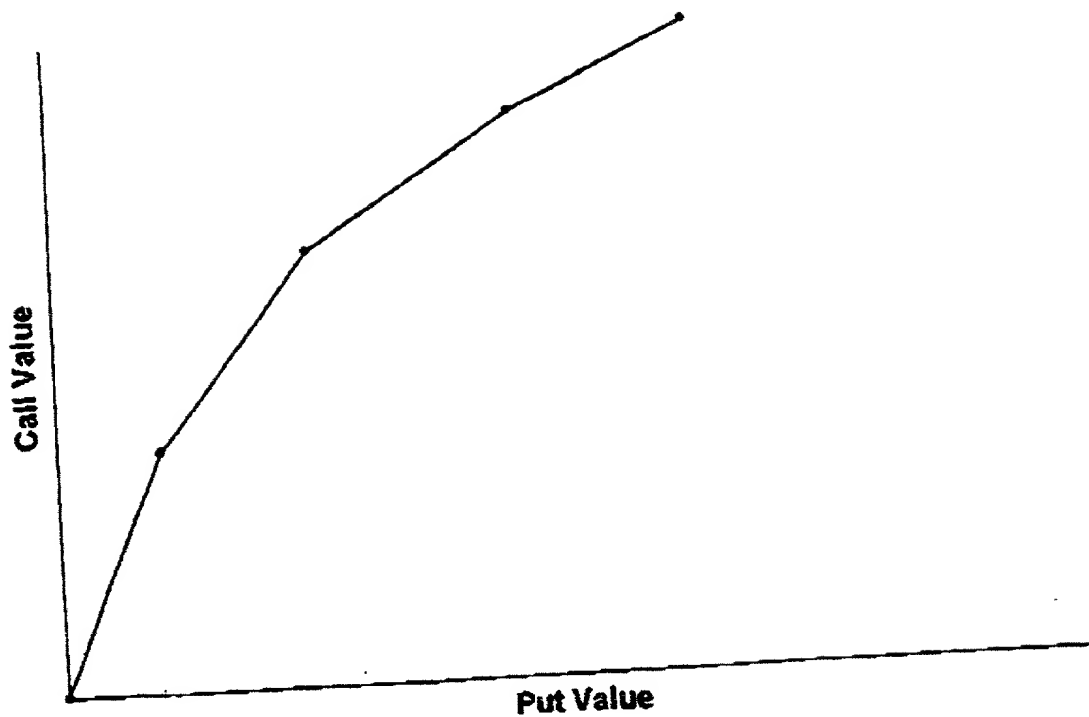


Figure 9

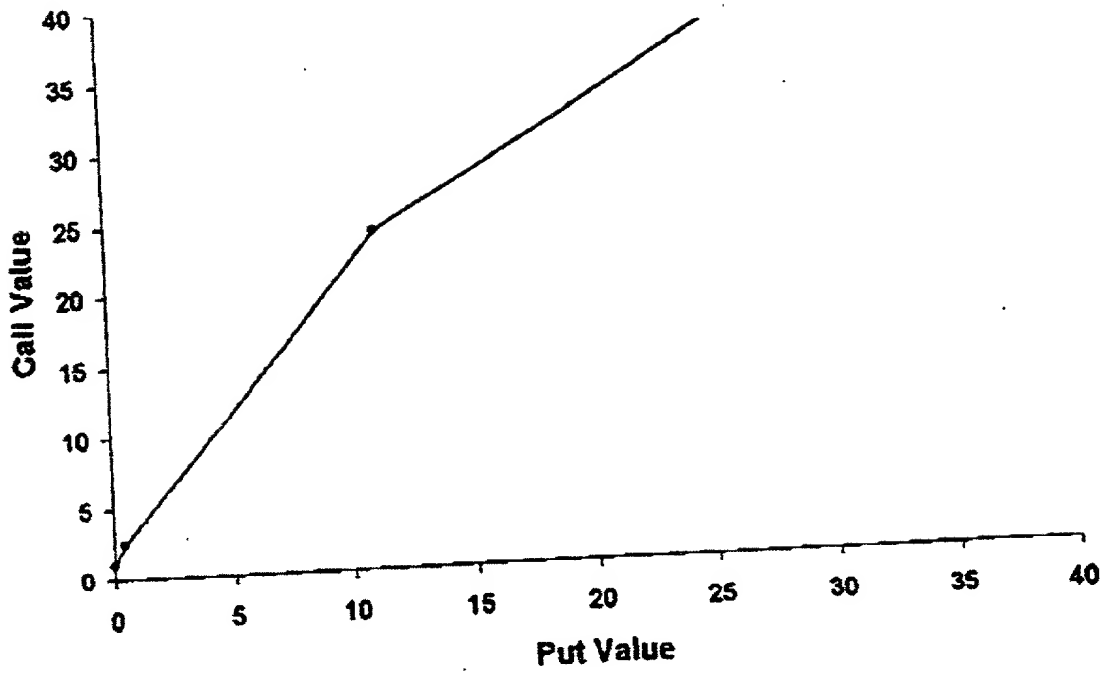


Figure 10

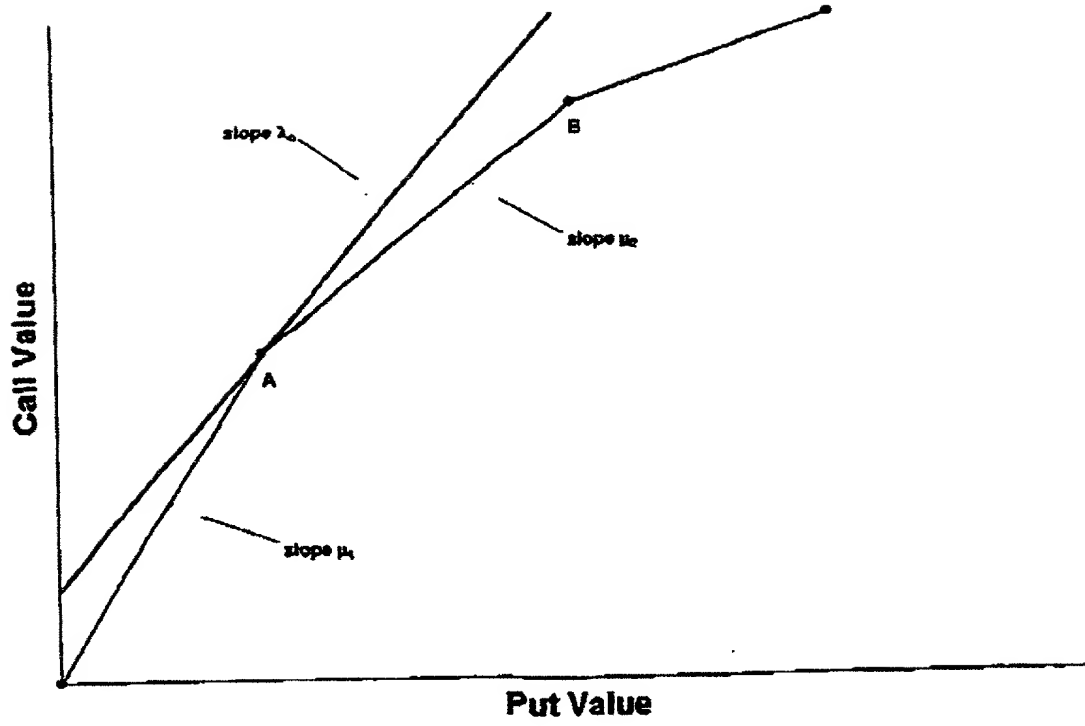


Figure 11

0042317 00537250

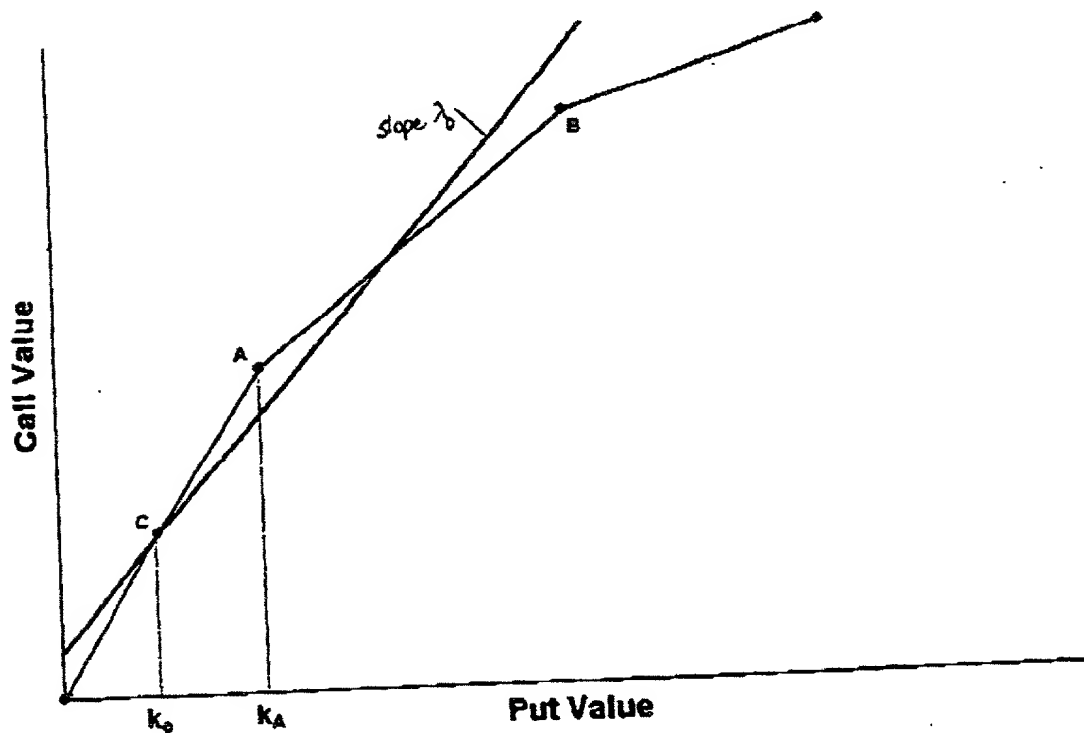
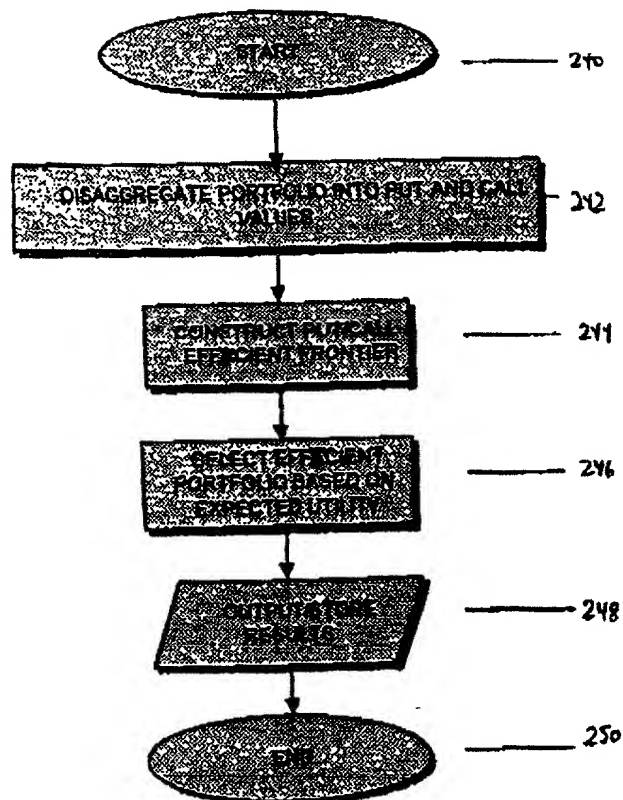


Figure 12

FIGURE 13



**BERESKIN & PARR**BOX 401, 40 KING STREET WEST, TORONTO, CANADA M5H 3T2  
PHONE (416) 564-7311 - FAX (416) 561-1598 - WWW.BERESKINPARR.COM

PTO/SB/01A (10-00)

Approved for use through 10/31/2002. OMB 0651-0032

U.S. Patent and Trademark Office: U.S. DEPARTMENT OF COMMERCE

Under the Paperwork Reduction Act of 1995, no persons are required to respond to a collection of information unless it displays a valid OMB control number.

**DECLARATION (37 CFR 1.63) FOR UTILITY OR DESIGN APPLICATION USING AN  
APPLICATION DATA SHEET (37 CFR 1.76)**

As the below named inventor(s), I/we declare that:

This declaration is directed to:

- ☒ The attached application, or  
☐ Application No. \_\_\_\_\_, filed on \_\_\_\_\_

☐ as amended on \_\_\_\_\_ (if applicable);

I/we believe that I/we am/are the original and first inventor(s) of the subject matter which is claimed and for which a patent is sought;

I/we have reviewed and understand the contents of the above-identified application, including the claims, as amended by any amendment specifically referred to above;

I/we acknowledge the duty to disclose to the United States Patent and Trademark Office all information known to me/us to be material to patentability as defined in 37 CFR 1.56, including material information which became available between the filing date of the prior application and the National or PCT International filing date of the continuation-in-part application, if applicable; and

All statements made herein of my/own knowledge are true, all statements made herein on information and belief are believed to be true, and further that these statements were made with the knowledge that willful false statements and the like are punishable by fine or imprisonment, or both, under 18 U.S.C. 1001, and may jeopardize the validity of the application or any patent issuing thereon.

**FULL NAME OF INVENTOR(S)**Inventor one: Ron S. DemboSignature: \_\_\_\_\_ Citizen of: CanadianInventor two: Helmut MausserSignature: \_\_\_\_\_ Citizen of: Canadian

Inventor three: \_\_\_\_\_

Signature: \_\_\_\_\_ Citizen of: \_\_\_\_\_

Inventor four: \_\_\_\_\_

Signature: \_\_\_\_\_ Citizen of: \_\_\_\_\_

☐ Additional inventors are being named on \_\_\_\_\_ additional form(s) attached hereto.

**Burden Hour Statement:** This collection of information is required by 35 U.S.C. 115 and 37 CFR 1.63. The information is used by the public to file (and the PTO to process) an application. Confidentiality is governed by 35 U.S.C. 122 and 37 CFR 1.14. This form is estimated to take 1 minute to complete. This time will vary depending upon the needs of the individual case. Any comments on the amount of time you are required to complete this form should be sent to the Chief Information Officer, U.S. Patent and Trademark Office, Washington, DC 20231. DO NOT SEND FEES OR COMPLETED FORMS TO THIS ADDRESS. SEND TO: Assistant Commissioner for Patents, Washington, DC 20231.

004427 "00507260